(3)

No. 83-1961

In the Supreme Court of the United States

OCTOBER TERM, 1984

LANDRETH TIMBER COMPANY, PETITIONER

v.

IVAN K. LANDRETH, ET AL., RESPONDENTS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether the sale of all of the stock in a company is a securities transaction subject to the antifraud provisions of the federal securities laws.

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INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, submits this brief as *amicus curiae* to address the question whether the sale of a controlling stock interest in a corporation is a "securities" transaction subject to the antifraud provisions of the federal securities laws. The court below held that a purchaser of a 100% stock interest is not entitled to the protections of those provisions. This ruling conflicts with decisions of the Courts of Appeals for the Second, Third,

Fourth, and Fifth Circuits.[1] Three other circuits adhere to versions of the "sale of business" doctrine endorsed by the court below.[2] Some lower courts have expanded this doctrine so far as to deny antifraud protections to purchasers of a 50% or less stock interest where the purchaser was found to have a role in corporate management.[3] The Court will hear a companion case, *Gould* v. *Ruefenacht*, cert. granted, No. 84-165 (Nov. 13, 1984), that presents the question whether the sale of a 50% stock interest is covered by the antifraud provisions of the federal securities laws.

The Commission disagrees with both the analysis employed and the result reached by the court below in this case and by other courts that have adopted the sale of business doctrine. Persons who bargain to

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[1] *Ruefenacht* v. *O'Halloran*, 737 F.2d 320 (3d Cir. 1984), cert. granted *sub nom. Gould* v. *Ruefenacht*, No. 84-165 (Nov. 13, 1984); *Daily* v. *Morgan*, 701 F.2d 496 (5th Cir. 1983); *Golden* v. *Garafalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin* v. *Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir.), cert. denied, 444 U.S. 868 (1979); see also *Cole* v. *PPG Industries, Inc.*, 680 F.2d 549 (8th Cir. 1982) (interpreting Arkansas law by reference to federal securities law).

[2] *Sutter* v. *Groen*, 687 F.2d 197 (7th Cir. 1982); *King* v. *Winkler*, 673 F.2d 342 (11th Cir. 1982); *Chandler* v. *Kew, Inc.*, 691 F.2d 443 (10th Cir. 1977).

[3] See, *e.g.*, *Ruefenacht* v. *O'Halloran*, Civ. No. 80-1097 (D.N.J. Apr. 15, 1983) (50% stock interest), rev'd, 737 F.2d 320 (3d Cir.), cert. granted *sub nom. Gould* v. *Ruefenacht*, No. 84-165 (Nov. 13, 1984); *Colson* v. *Bertsch*, 586 F. Supp. 1289 (D.N.J. 1984) (35%-49% stock interest); *Cadiz* v. *Jiminez*, 579 F. Supp. 1176 (D.P.R. 1983) (14% stock interest); *Oakhill Cemetery* v. *Tri-State Bank*, 513 F. Supp. 885 (N.D. Ill. 1981) (50% stock interest not a security if combined with corporate control).

purchase what is unquestionably stock should have the protection that investors reasonably expect to be associated with stock. In addition, adoption of the analysis underlying the sale of business doctrine could adversely affect protection for those who purchase instruments other than stock, such as notes and debt instruments. The resolution of the sale of business issue will not only affect private litigation but could also significantly affect enforcement actions brought by the Commission.

STATEMENT

This action arises out of the sale by respondents Ivan K. Landreth and his sons of all of the outstanding common stock of a timber company. Petitioner Landreth Timber Company, the successor to the corporation formed to acquire the common stock from the Landreth family, was owned by a small investor group, including Samuel Dennis, a Boston attorney; his client John Bolten, a retired businessman who lived in Florida; and several others (Pet. App. 2a).[4] Petitioner brought this action against the sellers seeking damages under the antifraud provisions of the federal securities laws.[5] Petitioner alleged that, in

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[4] Samuel Dennis originally executed the sale agreement. Before the closing on November 17, 1977, Dennis and the sellers agreed to assign the rights under the agreement to B & D Company, a corporation formed to complete the purchase (Pet. App. 2a). B & D merged with the timber company to form Landreth Timber Company (*ibid.*).

[5] The complaint sought relief under Sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77*l*(2) and 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), which are antifraud provisions. The complaint also sought relief for violations of registration requirements under Sections 5 and 12(1) of the Securities

connection with the sale, respondents had misrepresented or had omitted to state material facts concerning the liabilities of the timber company and the condition, production capacity, and completion cost of its principal asset, a partially-built sawmill (Second Amended Complaint ¶¶ 9-13, 24-25).

The district court granted respondents' motion for summary judgment, ruling that the transaction did not involve securities within the meaning of the federal securities laws. The district court acknowledged that the stock at issue possessed the characteristics of conventional "stock" (Pet. App. 13a), a term included in the statutory definition of a "security." Nevertheless, the court held that the stock could not be a security unless it met the test set forth in *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946), for identifying "investment contracts," another term included in the statutory definition of security. In the district court's view, this conclusion is mandated by *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975). Because the *Howey* test requires that anticipated profits be derived from the efforts of others, the court ordered the parties to submit facts bearing on managerial control. After reviewing the post-sale roles of the sellers and purchasers, the court found that the management of the business had passed into the hands of the purchasers (Pet. App. 19a-20a). On this basis, the court held that the petitioner did not satisfy the investment contract test.

The court of appeals affirmed (Pet. App. 1a-10a). It reasoned (Pet. App. 7a) that it should look beyond the statutory language in this case because it had previously done so in construing "note," another term in

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Act, 15 U.S.C. 77e and 77*l*(1), breach of contract, common law fraud, and violations of various state statutes.

the statutory definition of security. In adopting the sale of business doctrine, the court stated (Pet App. 8a): "[W]hen a person purchases control of a business, he does not make an investment from which he expects profits solely from the efforts of others. Although the transaction involves stock, the economic realities reflect acquisition of a business, not passive investment, and the [securities] Acts therefore do not apply." Thus, like the district court, the court of appeals held that an instrument that was undeniably common stock was not a security unless it satisfied the investment contract test set forth in *Howey*.

SUMMARY OF ARGUMENT

I.

The plain language of the federal securities laws, the structure of those statutes, and their legislative history, all support the conclusion that petitioner's purchase of ordinary common stock was a securities transaction. With respect to the status under the securities laws of ordinary common stock, the statutory language is clear—the term "stock" is expressly included in the statutory definition of "security." Excluding conventional common stock from the coverage of the securities laws because it does not also meet the test for an "investment contract," another specifically enumerated term in the statutory definition of security, violates established canons of statutory construction. In addition, the structure of the federal securities laws refutes respondents' suggestion that the sale of business doctrine should be adopted because those laws are not concerned with private transactions or transactions involving transfer of control; numerous provisions in those laws are

concerned with such matters. Furthermore, nothing in the legislative history of the securities laws supports respondents' position that the sale of a controlling stock interest should be construed to be outside the express coverage of those laws. Instead, the legislative history supports a broad reading of "security."

II.

This Court's decision in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), warrants no departure from the plain meaning of the statute. *Forman* did not hold that the investment contract test must be applied to all types of securities, including ordinary corporate stock; rather, *Forman* held that so-called "stock" entitling the purchaser to lease an apartment was not a security. In reaching its decision, the Court utilized the investment contract test only after concluding that the "stock" at issue in that case did not come within the statutory term "stock" because it did not possess the characteristics typically associated with that type of instrument. In contrast to *Forman*, the instruments in the present case possess all of the characteristics of conventional stock.

Nor does this Court's decision in *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982), support adoption of the sale of business doctrine. The Court in *Weaver* relied on the prefatory clause to the statutory definitions, "unless the context otherwise requires," to hold that, in light of the comprehensive scheme under which federally regulated and insured banks conduct business, certificates of deposit of such banks should not be deemed securities for purposes of the antifraud provisions of the federal securities laws. There is no comparable alternative federal comprehensive regulatory scheme here.

III.

Important policy considerations counsel rejection of the sale of business doctrine. Application of that doctrine would require an inquiry into the nebulous area of corporate control and would create arbitrary distinctions among transactions and among their participants. The only certain result of adopting the doctrine would be an increased burden on the federal courts and on litigants. In addition, purchasers of conventional stock should not be excluded from the protections of the securities laws simply because they intend to play a role in the operation of the business. The possibility of fraud is not eliminated because the purchaser acquires a controlling stock interest. Furthermore, the alleged fraud in this case related to the condition of the corporation and value of the stock at the time of its purchase. At that time petition was no less a passive investor than one who buys shares in the market. Finally, contrary to respondents' argument, a stock sale is not the same as an asset sale; the risks and consequences of the two types of transactions are substantially different.

ARGUMENT

I. IN VIEW OF THE PLAIN LANGUAGE, THE STRUCTURE, AND THE LEGISLATIVE HISTORY OF THE FEDERAL SECURITIES LAWS, PETITIONER'S PURCHASE OF CONVENTIONAL COMMON STOCK WAS A SECURITIES TRANSACTION

A. "The starting point in every case involving construction of a statute is the language itself." *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551, 558 (1979), quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). With respect to the status under the

federal securities laws of ordinary common stock, the statutory language could not be more clear. The term "security" is defined in both the Securities Act of 1933 and the Securities Exchange Act of 1934 to include "stock."[6] Although not defined in the Acts, "stock" carries a well-defined meaning. *SEC* v *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). See *Ballentine's Law Dictionary* 1236 (2d ed. 1930): "As the term is used in connection with corporations, it means the capital of the corporation * * *." By its nature, stock represents both ownership and control, conferring the right "to participate in the general management of the company." *Black's Law Dictionary* 1660 (3d ed. 1933). The district court concluded in this case that the timber company's stock "possessed the ordinary characteristics of stock" (Pet. App. 13a), and it is not disputed that the instruments purchased by petitioner were conventional common stock.

"Investment contract" is also specifically enumerated in the statutory definition of security. See note

[6] Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), provides:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement, * * * investment contract, voting-trust certificate, * * * or in general, any instrument commonly known as a "security" * * *.

Section 2(1) of the Securities Act, 15 U.S.C. 77b(1), is virtually identical. *Marine Bank* v. *Weaver*, 455 U.S. 551, 555 n.3 (1982). All 40 definitions in the 1934 Act, 15 U.S.C. 78c(a), and all 15 definitions in the 1933 Act, 15 U.S.C. 77b, are preceded by the statutory language "When used in this [chapter], unless the context otherwise requires * * *." See pages 19-21, *infra*.

6, *supra*. Unlike "stock," "investment contract" is a general term designed to ensure that novel, unconventional, or irregular instruments that might not be considered securities in normal parlance are covered by the securities laws. See *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946); *C.M. Joiner Leasing Corp.*, 320 U.S. at 351. Thus, by including the term "investment contract" in the definition of "security," Congress *broadened* the definition to include more than ordinary stocks and bonds.

The court of appeals held that the purchase of stock by petitioner was not a securities transaction because it did not satisfy the test set forth in *SEC* v. *W.J. Howey Co.*, *supra*, for determining whether a novel instrument is an investment contract: that it "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U.S. at 301 (see Pet. App. 8a). But invoking the investment contract test to determine the status under the securities laws of stock—a separate term in the definition of security—violates established canons of statutory construction.

A statute should be construed "to give effect, if possible, to every clause and word of a statute." *United States* v. *Menasche*, 348 U.S. 528, 538-539 (1955), quoting *Montclair* v. *Ramsdell*, 107 U.S. 147, 152 (1882). See also 2A N. Singer, *Statutes and Statutory Construction* § 46.06 (4th rev. ed. 1984). Indeed, "[t]here was little reason for the drafters to use words such as 'stock,' 'treasury stock,' or 'voting-trust certificate,' unless their intention was to include all such instruments as commonly defined." *Golden* v. *Garafalo*, 678 F.2d at 1144. It is apparent from the statutory language that investment contracts are properly viewed as only one of "the several types of

instruments designated as securities" under the definitional sections of the securities laws. *Tcherepnin* v. *Knight*, 389 U.S. 332, 338 (1967). Once the court concluded that the instruments purchased by petitioner were ordinary common stock, it should have ended its inquiry and held that those instruments were securities.[7]

The court of appeals reasoned (Pet. App. 7a-9a) that it should use a transactional analysis in construing "stock" because it had previously used such an analysis in defining "note," another term in the statutory definitions of security.[8] But "note" and "stock" are very different sorts of terms. "Note" is a vague

[7] This Court first interpreted the meaning of security in *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943). That case made clear that Congress did not intend the more general terms in the Securities Act definition of "security," such as "investment contract," to be construed narrowly on account of the more specific terms, such as "stock" and "bond." Instead, the Court held that the term "investment contract" *broadens* the definition of "security" to include instruments other than traditional stocks and bonds. The conclusion of the court below that the general phrase "investment contract" *circumscribes* the scope of "stock", a specific term, "turn[s] the history of the Acts * * * on their heads." *Ruefenacht* v. *O'Halloran*, 737 F.2d at 329.

[8] The Ninth Circuit uses a "risk capital" test to determine whether a note is a security. *Great Western Bank & Trust Co.* v. *Kotz*, 532 F.2d 1252, 1257-1258 (1976). Most other courts of appeals have adopted the "commercial-investment dichotomy" in determining whether notes are securities. See, *e.g.*, *Bellah* v. *First National Bank*, 495 F.2d 1109, 1111-1114 (5th Cir. 1974). The Second Circuit has taken a slightly different approach. It begins with a presumption that the statute encompasses any note, but excludes notes bearing a "family resemblance" to consumer or commercial transactions. See *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d 1126, 1137-1138 (1976).

term meaning nothing more than a promise to pay money. *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1347 (9th Cir. 1983). It includes investment instruments as well as commercial loan transactions and consumer payment plans.[9] Accordingly, courts have found it necessary to look at various factors relating to the transaction at issue, rather than just to the instrument itself, to determine whether a particular note is covered by the securities laws. See, *e.g.*, *C.N.S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1361-1362 (7th Cir.), cert. denied, 423 U.S. 825 (1975); *McClure* v. *First National Bank*, 497 F.2d 490, 494 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975). "Stock," in contrast, is a precise term denoting an easily recognizable, conventional instrument with common characteristics. Thus, in the case of ordinary stock, analysis of the transaction at issue is not required. See *Ruefenacht* v. *O'Halloran*, 737 F.2d at 325. If an instrument is ordinary stock, which has a traditional and accepted meaning and which "represents to many people, both trained and untrained in business matters, the paradigm of a security" (*Daily* v. *Morgan*, 701 F.2d at 500), it is not necessary to look beyond the instrument to determine whether it is a security.[10]

[9] See, *e.g.*, *Hunssinger* v. *Rockford Business Credit, Inc.*, 745 F.2d 484 (7th Cir. 1984); *Zabriskie* v. *Lewis*, 507 F.2d 546 (10th Cir. 1974); *Bellah* v. *First National Bank*, 495 F.2d 1109 (5th Cir. 1974).

[10] As Professor Loss has stated in criticizing the sale of business doctrine: "It is one thing to say [as was held in *Forman*] that the typical cooperative apartment dweller has bought a home, not a security * * *. But *stock* (except for the residential wrinkle) is so quintessentially a security as to foreclose further analysis." L. Loss, *Fundamentals of Securities Regulation* 212 (1983) (emphasis in original).

B. The statutory scheme of the federal securities laws supports rejection of the sale of business doctrine. Contrary to the suggestion of respondents (Br. in Opp. 3, 6), the antifraud provisions of the securities laws apply to private, negotiated transactions.[11] While transactions not involving a public offering are exempt from the registration requirements (see Section 4(2) of the Securities Act, 15 U.S.C. 77d(2)), there is no comparable exemption from antifraud liability.[12] "Thus, the coverage of the antifraud provisions of the securities laws is not limited to instruments traded at securities exchanges and over-the-counter markets * * *." *Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982). These provisions have "always been understood to apply to transactions in shares of close as well as publicly held corporations and to negotiated as well as market sales and purchases of shares." *Golden* v. *Garafalo*, 678 F.2d at 1146-1147 (citing *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971)).[13]

[11] Professor Loss has characterized that doctrine as coming "dangerously close to the heresy of saying that the fraud provisions do not apply to private transactions." L. Loss, *supra*, at 212; see note 10, *supra*.

[12] The Fifth Circuit in *Daily* v. *Morgan* emphasized (701 F.2d at 502):

> If Congress had wanted to exempt the privately negotiated sale of a controlling interest of stock in a small business from [the] antifraud provision [of Section 10(b)] it could have done so. * * * Congress could and did exempt small, private sales of stock from many of the requirements of the securities laws, but chose to apply the section 10(b) antifraud provision to all stock.

[13] The analysis of this Court in *Weaver*, in holding that a negotiated loan agreement was not a security, does not suggest a contrary conclusion. In reaching the determination that a unique agreement between two families, which included arrangements for the use of a barn and pasture, was not a security, that opinion distinguished "those instruments ordinarily and commonly considered to be securities in the commercial world"—which the securities laws were plainly intended to cover—from "unusual instruments," such as the investment contracts at issue in *Howey*. 455 U.S. at 559. As this Court in *Weaver* explained, "[t]he *unusual* instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction * * *[,] had equivalent values to most people and could have been traded publicly." *Id.* at 559-560 (emphasis added). Thus, while the Court recognized (*id.* at 559-560 & n.11) that novel instruments are properly subject to transactional analysis in order to determine whether they are investment contracts, it did not suggest such an analysis for stock or other conventional instruments.

Nor do the securities laws exclude transactions affecting the transfer of controlling stock interests, as respondents suggest (Br. in Opp. 8). On the contrary, the Securities Exchange Act contains provisions specifically covering tender offers, disclosure of transactions by corporate directors, officers, and principal stockholders, and the recovery of short-swing profits garnered by such persons. See, *e.g.*, Sections 14 and 16 of the Securities Exchange Act of 1934, 15 U.S.C. 78n, 78p. See also *Daily* v. *Morgan*, 701 F.2d at 503 ("a rule that turns on the transfer of control would logically exclude from the reach of Rule 10b-5 many tender offer battles"). Thus, the securities laws themselves refute the notion that those laws were intended only to cover passive investors purchasing minority interests.

C. The legislative history provides no justification for the sale of business doctrine. Rather, it supports a broad reading of the term "security." Congress did not specifically address the sale of business issue, but

the House Report accompanying what became the Securities Act explains that the term "security" was intended to cover the "many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. Rep. 85, 73d Cong., 1st Sess. 11 (1933). This statement supports "the proposition that instruments ordinarily regarded as 'stock' are a 'security', notwithstanding that the underlying transaction involves a transfer of control. This understanding of Congressional intent, moreover, has been almost universally accepted by the courts, the relevant agency and the bar for over 40 years." *Golden* v. *Garafalo*, 678 F.2d at 1144-1145.[14] In the face of legislative silence as to the precise issue presented here, courts should assume "that the legislative purpose is expressed by the ordinary meaning of the words used." *Securities Industry Ass'n* v. *Board of Governors of the Federal Reserve System*, No. 82-1766 (June 28, 1984), slip op. 11 (quoting *Russello* v. *United States*, No. 82-472 (Nov. 1, 1983), slip op. 4; *Richards* v. *United States*, 369 U.S. 1, 9 (1962)).[15]

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[14] This Court has recognized that investor protection is not the sole purpose of the securities laws. See *United States* v. *Naftalin*, 441 U.S. 768, 776 (1979) (quoting S. Rep. 42, 73d Cong., 1st Sess. 1 (1933); 77 Cong. Rec. 2925 (1933) (remarks of Rep. Kelly); *id.* at 2935 (remarks of Rep. Chapman) (acknowledging congressional concern with protecting "honest corporate business" and "ethical business men").

[15] This Court recently rejected an argument similar to respondents' in *Securities Industry Ass'n* v. *Board of Governors of the Federal Reserve System*, No. 82-1766 (June 28, 1984). In construing the Banking Act of 1933 (the Glass-Steagall Act), enacted by Congress only weeks after the Securities Act, this Court held that the terms "notes or other securities" which appear in Section 21(a)(1) of that Act, 12 U.S.C. 378(a)(1), together with the terms "stocks" and "bonds," should not be narrowed to include only instruments that share characteristics "of an investment" common to the other named instruments. *Securities Industry Ass'n*, slip op. 11-16. Such a restrictive reading, this Court pointed out, is not indicated by the phrasing of the statutory sections, is inconsistent with the broad statutory scheme, and is not supported by the legislative history. *Ibid.* Each of these conclusions is equally applicable and compelling here.

II. PRIOR HOLDINGS OF THIS COURT SUPPORT THE CONCLUSION THAT PETITIONER'S PURCHASE OF COMMON STOCK WAS A SECURITIES TRANSACTION

A. This Court's decision in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), warrants no departure from the plain language of the statute. *Forman* did not hold, as respondents (Br. in Opp. 9) claim, that the investment contract test formulated in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), is the sine qua non for all securities, including ordinary stock in a business corporation. Nor did that case establish a single "economic reality" test (Pet. App. 7a-8a). Indeed, the two-part analysis that the Court used in *Forman* bolsters the conclusion that the investment contract test is not applicable to instruments that come within one of the specific statutory terms in the definition of security. *Ruefenacht* v. *O'Halloran*, 737 F.2d at 338.

The plaintiffs in *Forman* purchased shares of "stock" in a cooperative housing corporation entitling them to apartments in a state-subsidized and supervised non-profit housing cooperative. They acquired this "stock" solely to obtain a place to live, the number of shares being proportionate to the number of rooms in the apartment. The 'stock" lacked the characteristics of ordinary stock. It paid no dividends and could not be pledged, encumbered, or transferred

to a non-tenant. Each apartment owner was entitled to one vote, regardless of the number of shares held. Any tenant terminating his occupancy was required to resell the "stock" to the issuer at the initial selling price or, under certain circumstances, to sell to a qualifying replacement tenant at virtually the same price. 421 U.S. at 842-843, 851.

In ruling that the so-called "stock" interests were not "securities," the Court engaged in a two-step analysis: it first considered whether they were securities by virtue of coming within the definitional term "stock"; and, then, alternatively, the Court considered whether they were securities by virtue of coming within a more general definitional term, such as "investment contract." With respect to the first question, this Court recognized that an instrument should not be deemed to be a security simply because someone chose to call it "stock." The Court explicitly acknowledged, however, that the name given an instrument may be highly pertinent (421 U.S. at 850-851):

> In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

The *Forman* Court concluded that the purchasers in that case were not misled by the word "stock" because the shares they had bought bore none of the indicia typically associated with stock. In so holding,

the Court identified five characteristics of stock: (1) the right to receive dividends contingent upon an apportionment of profits; (2) negotiability; (3) the ability to be used as collateral; (4) voting rights in proportion to the number of shares owned; and (5) share appreciation. *Id.* at 851. Judged by such criteria, the cooperative shares were not instruments "that in our commercial world fall within the ordinary concept of a security" (*ibid.*; quoting H.R. Rep. 85, 73d Cong., 1st Sess. 11 (1933)). Thus, the Court held that, as a matter of economic reality, the plaintiffs in *Forman* had not purchased stock within the meaning of the securities laws.

The Court then examined the instrument to determine whether it nonetheless constituted a security by coming within one of the more general terms that also appear in the statutory definition, including "investment contract" and "an instrument commonly known as a 'security'." 421 U.S. at 851-858.[16] Applying the *Howey* test, the Court concluded that because the purchasers of the cooperative housing corporation shares wanted only to acquire living quarters for personal use, not to make an investment in the hope of

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[16] In *Forman*, the Court stated that the investment contract test applies to both terms. 421 U.S. at 852. ("We perceive no distinction for present purposes, between an 'investment contract' and an 'instrument commonly known as a "security."' * * * The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."). The Court did not thereby imply that the same test would govern the more specific terms, such as "stock," "bond," or "debenture." But see *King* v. *Winkler*, 673 F.2d at 344-345 (construing the quoted language in *Forman* as mandating that test for conventional instruments such as stock).

receiving profits from the efforts of others, their "stock" was not an investment contract.[17]

In reaching that conclusion, the Court observed (421 U.S. at 852-853) that the *Howey* test "embodies the essential attributes that run through all of the Court's decisions defining a security." Contrary to respondents' contention (Br. in Opp. 9), the Court, in making that statement, was "merely describing its past decisions," all of which happened to deal with unusual or unconventional instruments. *Daily* v. *Morgan*, 701 F.2d at 499-500.[18] It was not referring to any decision construing the term "stock." The Court has not suggested that the *Howey* test should be "invoked ritualistically whenever the existence of a security is at issue." *Meason* v. *Bank of Miami*,

[17] The court of appeals had relied on the investment contract analysis as an alternative basis upon which to conclude that the "stock" involved in that case was a security. 421 U.S. at 846.

[18] See *Tcherepnin* v. *Knight*, *supra* (involving withdrawable capital shares of a savings and loan association); *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (involving combined variable and fixed annuity); *SEC* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (involving variable annuity contract); *SEC* v. *W.J. Howey Co.*, *supra* (involving sales of citrus acreage coupled with optional service contracts to cultivate the crops); *SEC* v. *C.M. Joiner Leasing Corp.*, *supra* (involving sales of assignments of oil leases).

International Brotherhood of Teamsters v. *Daniel*, 439 U.S. 551 (1979), which reiterated the *Forman* description of past decisions by the Court (439 U.S. at 558 n.11), likewise lends no support to the sale of business doctrine. That case dealt with a participation in a pension plan, an interest which, unlike stock, is not enumerated in the statutory definition. Since a pension interest could not be a security unless it came within a general term, it is hardly surprising that this Court discussed the interest under the rubric of investment contract.

652 F.2d 542, 549 (5th Cir. 1981), cert. denied, 455 U.S. 939 (1982). Rather, "the Court has applied the *Howey* test when considerations pertinent to an investment contract applied to the instrument in question" (*ibid.*).[19] Thus, in *Forman* this Court utilized that test only to determine whether the cooperative shares, which it had already concluded were not conventional stock, were nonetheless securities in the form of an investment contract. But, as stated in *Coffin* v. *Polishing Machines, Inc.*, 596 F.2d 1202, 1204 (4th Cir.), cert. denied, 444 U.S. 868 (1979), "[a]bsent some showing that ordinary corporate stocks are other than what they appear to be," application of the *Howey* test is inappropriate.

B. In urging an interpretation contrary to the statutory language and legislative history, respondents, citing *Marine Bank* v. *Weaver*, *supra*, point (Br. in Opp. 7-18, 12) to the clause "unless the context otherwise requires," which precedes the definitional sections.[20] In *Weaver*, the Court, relying on that

[19] Application of the investment contract test in all cases could result in decisions excluding many instruments commonly thought of as securities from the protection of the antifraud provisions of the securities laws because that test includes criteria that instruments specifically enumerated in the statutory definition may not meet. For example, some lower courts have suggested instruments paying a fixed interest do not meet the "profits" element of that test. *Briggs* v. *Sterner*, 529 F. Supp. 1155, 1168 (S.D. Iowa 1981). See generally, *Hunssinger* v. *Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) (if *Howey* applied to all instruments, many instruments assumed to be securities, including twenty year corporate bonds, would not be securities because they could not meet the definition of "profit").

[20] The Seventh Circuit in *Sutter* v. *Groen*, 687 F.2d at 200-201, also relied on *Weaver* to support the sale of business doctrine.

clause, held that, in the light of the comprehensive scheme under which federally regulated and insured banks conduct business, certificates of deposit of such banks are not securities for purposes of the antifraud provisions of the federal securities laws.[21] The Court concluded in *Weaver* that holders of such bank certificates of deposit are abundantly protected under the federal banking laws, and thus imposition of another federal statutory scheme would contravene Congressional intent. 455 U.S. at 558-559. No such contextual considerations are relevant here, because there is no alternative federal comprehensive regulatory scheme.[22]

As Judge Friendly emphasized in *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d at 1137-

[21] The Securities and Exchange Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation filed a brief *amicus curiae* urging that position.

[22] Respondents suggest (Br. in Opp. 13) that the petitioner has an adequate remedy under state law. However, as the Third Circuit has observed:

> The premise that common-law remedies are necessarily adequate in the sale-of-business context is flawed. The defendant, for example, may prove to be insolvent, prompting the plaintiff to seek out solvent defendants among those parties who may be sued by virtue of the absence of privity requirements under federal law. Congress, moreover, did not confine the protection of federal law to instances in which no adequate common-law remedy could be had. The Acts, for example, confer additional benefits on parties victimized by fraud, including the absence of express defenses and certain procedural advantages.

Ruefenacht v. *O'Halloran*, 737 F.2d at 336 (footnotes omitted).

1138 (emphasis in original), a party who relies on the "unless the context otherwise requires" language of the statutory definitions—when an instrument fits within their plain terms—to argue that the antifraud provisions are not applicable "has the burden of showing that 'the context otherwise *requires*.'"[23] *Weaver* involved an exceptional situation where the context did so require. Certainly, the context of the present case, in which petitioner's interest comes within the fundamental Congressional purpose of protecting purchasers and sellers of stock, does not justify a departure from the statutory language.

III. IMPORTANT POLICY CONSIDERATIONS ALSO COUNSEL REJECTION OF THE SALE OF BUSINESS DOCTRINE

A. "The most prominent feature of the sale-of-business doctrine is its attendant uncertainty of application * * *." *Ruefenacht* v. *O'Halloran*, 737 F.2d at 332. The inability of parties to a transaction to predict whether the securities laws are applicable "raises the cost of economic transactions, inhibits the flow of capital, spawns litigation, and in general benefits neither the parties nor the court." *Id.* at 333. A major source of uncertainty is the reliance by courts adopting the sale of business doctrine on whether the purchaser intends to manage or has "control" of the corporation (see Pet. App. 9a). This threshold inquiry is by no means simple. Purchasers

[23] The court added: "So long as the statutes remain as they have been for over forty years, courts had better not depart from their words without strong support for the conviction that, under the authority vested in them by the 'context' clause, they are doing what Congress wanted when they refuse to do what it said." 544 F.2d at 1138.

have varying degrees of intent to manage, and their intentions may not be fixed or may in any case change.[24] Likewise, determining who has control of a corporation can be an elusive inquiry.[25] "Wholly apart from the oddity of making what a security *is* depend upon these factors, they raise the prospect of a substantial hearing in many cases simply to determine whether an instrument is a 'security.'" *Ruefenacht* v. *O'Halloran*, 737 F.2d at 332 (emphasis in original).[26] "Without some clearer directive from

[24] As one court has explained:

> If intent to manage [the acquired corporation] is relevant, adoption of the [sale of business] doctrine will lead to countless issues of mixed fact and law such as whether part-time managers are passive or active, what classification to accord controlling shareholders who intervene sporadically, and the status of new investors who assume ambiguous roles as employees or who intend initially to remain passive but are soon forced into management roles.

Golden v. *Garafalo*, 678 F.2d at 1145-1146.

[25] The Third Circuit addressed some of the problems in determining who has control:

> Control may be exercised, for example, by alliances of minority shareholder factions. One indicator of whether a minority share effectively exercises control might be whether the purchase price of the share exceeded the prevailing market price. Another might be the voting patterns of various factions. * * * [T]estimony might be taken on the intent of the purchasers and the realities of corporate management.

Ruefenacht v. *O'Halloran*, 737 F.2d at 332.

[26] The Seventh Circuit, which requires such an inquiry in cases involving stock transfers, has fashioned a "main purpose" test, whereby a purchaser who has acquired more than 50% but less than 100% of a corporation's stock will be

Congress that it intended the statutory terms to involve the nebulous inquiry" required by the sale of business doctrine, there is no reason "to narrow the ordinary meaning of the statutory language." *Securities Industry Ass'n* v. *Board of Governors of the Federal Reserve System*, No. 82-1766 (June 28, 1984), slip op. 13-14.

The sale of business doctrine also creates arbitrary distinctions among transactions and among their participants. For example, in the event a single purchaser bought 100% of the shares of a corporation from an 80% seller and various minority holders, the doctrine could lead to the anomalous result that the minority sellers would be deemed to have engaged in securities transactions, while the purchaser and 80% seller would not. Compare *Frederiksen* v. *Poloway*, 637 F.2d 1147 (7th Cir.), cert. denied, 451 U.S. 1017 (1981) (holding that the purchaser of 100% of the stock in a company did not acquire securities), with *McGrath* v. *Zenith Radio Corp.*, 651 F.2d 458 (7th Cir.), cert. denied, 454 U.S. 835 (1981) (concluding that the selling shareholders on the other side of such a transaction *could* maintain an action for antifraud violations).[27] Such a variable standard "would

presumed to have made the acquisition for "entrepreneurship rather than investment," unless the purchaser can show that his "main purpose" was investment. *Sutter* v. *Groen*, 687 F.2d at 203. As described (pages 24-26, *infra*), there is no statutory or policy basis for drawing this distinction.

[27] By using terms such as "stock" and "bond," Congress drew on well-settled state-law definitions. See *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. at 351. The meaning of such terms was not dependent on who

> owned the instrument at any particular moment, and did not admit of asymmetries between buyer and seller. * * * Fluctuations in the identity of the instrument were foreign to the notion of stock. The chameleon-like quality

be difficult to apply and [would] create a capricious basis for dispensing the protection" of the securities laws. *Occidental Life Insurance Co.* v. *Pat Ryan & Associates, Inc.*, 496 F.2d 1255, 1263 (4th Cir.), cert. denied, 419 U.S. 1023 (1974).[28]

B. There is no warrant for excluding purchasers of conventional stock from the protections of the securities laws on the notion that an entrepreneur is essentially different from an investor (see Pet. App. 7a). Investors often participate in management in order to protect their interest. *Ruefenacht* v. *O'Halloran*, 737 F.2d at 334. " 'Had Congress intended so fundamental a distinction, it would have expressed that intent clearly in the statutory language or the legislative history.' " *Securities Industry Ass'n*, slip op. 14-15 (quoting *American Tobacco Co.* v. *Patterson*, 456 U.S. 63, 72 n.6 (1982)). Nor does "telling a defrauded purchaser that he has no federal remedy because he is an 'entrepreneur' and not an 'investor' " appeal to any "abstract sense of fairness." *Daily* v. *Morgan*,

of stock under the sale-of-business doctrine is wholly arbitrary with respect to the state-law definitions that are the source of the terms in the 1933 and 1934 Acts.

Ruefenacht v. *O'Halloran*, 737 F.2d at 336.

[28] This Court's decision in *Marine Bank* v. *Weaver*, *supra*, lends no support to the notion that an instrument may or may not be a security depending on the circumstances of the particular transaction—*i.e.*, that the same share of stock which is a security when it is sold today, may not be a security when it is resold tomorrow. As noted, *Weaver* focused on the federal regulatory scheme governing certificates of deposit issued by banks. The Court did not consider the transactional context in that case and, indeed, "reject[ed] respondents' argument that the certificate of deposit was somehow transformed into a security when it was pledged, even though it was not a security when purchased." 455 U.S. at 559 n.9.

701 F.2d at 503. Indeed, it has been suggested that a large purchaser may have a "more pressing need for protection to the extent that he has expended a greater amount of his resources." *Occidental Life Insurance Co.* v. *Pat Ryan & Associates, Inc.*, 496 F.2d at 1263.

The fact that the petitioner may not be a "passive" (Pet. App. 8a) or unsophisticated investor is no reason to foreclose it from bringing suit under the antifraud provisions of the securities laws (see Resp. Br. in Opp. 3, 4). Those protections are not limited to the unsophisticated.[29] The possibility of fraud, as alleged here, is not eliminated because the purchaser acquires a controlling stock interest. As demonstrated by recent history, management of even closely regulated companies can deceive their auditors and regulators. See *e.g.*, *Dirks* v. *SEC*, 463 U.S. 646 (1983) (describing the fraud practiced by Equity Funding Corporation of America).[30]

[29] The Second Circuit pointed out in a case involving a Chicago bank and a New York Stock Exchange member brokerage firm, *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d at 1137: "While banks are in a favored position to obtain disclosure, the target of §§ 10(b) of the 1934 Act and 17(a) of the 1933 Act is fraud, which a bank's ability to obtain disclosure cannot always prevent."

[30] "One of Congress' purposes in singling out the named instruments in the Act was to facilitate [non-market] transactions [in those instruments] without the ensuing delays, duplication of effort, and expenses associated with the 'caveat-stockholder' era of deregulation." *Ruefenacht* v. *O'Halloran*, 737 F.2d at 333 (citing H.R. Rep. 1383, 73d Cong., 2d Sess. 4-5 (1934)). The sale of business doctrine represents a return to that era. It may be true that in the absence of statutory protection against material misrepresentations, certain purchasers would be able to hire a team of accountants and attorneys to uncover adroitly hidden liabilities or other

Like any securities investor, the petitioner and its investor group were concerned with the value of the stock they were acquiring, and were seeking to make a profit which would be reflected in the price of those shares. The extent of petitioner's present ownership interest and of its present power to affect policies of the corporation provides no basis for denying it protection under the federal securities laws. The alleged fraud occurred in connection with the purchase, and related to the condition and circumstances of the corporation and the value of the stock at the time of purchase. Petitioner was then no less a passive investor than a person who buys shares in the market.

C. Finally, contrary to the view of the court below (see Pet. App. 8a), the difference between a sale of a majority or 100% stock interest and a sale of assets is not merely one of form: "Generally speaking, one who purchases the assets of a business is not liable for its debts and liabilities, while one who purchases the stock in a corporation—a separate legal entity—assumes ownership of a business with both assets and liabilities." *Daily* v. *Morgan*, 701 F.2d at 504 (citations omitted). Thus, buyers of business enterprises may very well wish to consider, in the mix of tax, personal liability, and other factors bearing on whether the transaction should be structured as a transfer of stock or assets, the need for antifraud protection. Since "[l]iabilities * * * are often the subject of inaccurate or incomplete disclosures" (*ibid.*), antifraud protection may be particularly important in the context of a stock sale. Here, the parties chose to structure their deal, not as a sale of

concealed facts. However, such an inquiry would be both costly and inefficient.

assets, but as a stock sale.[31] Under these circumstances, respondents, who are accused of fraudulently misrepresenting the timber company's liabilities, are in a poor position to challenge the expectation that the antifraud provisions would apply. See *Daily* v. *Morgan*, 701 F.2d at 503.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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[31] An assumption by petitioner that the antifraud provisions would apply to this sale would have been reasonable where, as here, the stock purchased has all the traditional attributes commonly associated with stock ownership. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. at 850-851.

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